CHAPTER **8**

The Budgeting Process

Chapter Objectives

- **Know how to create a budget.**
- **Undertake variance analysis.**
- **Distinguish between long- and short-term financial planning and understand how to minimize risk.**
- **Utilize break-even analysis to examine whether a budget is accurate.**
- **Respond to financial changes in real time.**

Key Terms

- **Variable costs are those costs that change in direct relation to the number of items or products that might be consumed or the number of fans in attendance (e.g., concession food costs).**
- **Fixed costs remain constant and are independent of the level of organizational activity. Using the concession example, the fixed costs would include the refrigeration and cooking equipment that incur an expense regardless of how many food items are sold.**
- **Forecasting is the process of determining what revenue and expenses might appear in the future.**

Data

- **Data is information that can help make financial decisions.**
- **Data is the simple ingredient needed to make a budget.**

Data for Financial Planning

- **Internal data—Often referred to as primary data, this information is generated by the business itself.**
- **External (secondary) data—Data obtained from other sources (e.g., newspapers, databases, teams, leagues, trade associations)**

Internal Data

- **Internal data can include past balance sheets and income statements, audited financial records, annual reports, research and development reports, e-mails, surveys, and countless other documents generated by employees or consultants.**
- **By breaking its operation down into its basic elements based on internal data, a team can develop a more appropriate budget.**
  - **One example is zero-based budgeting where every expenditure is justified in comparison with other potential projects in the organization. Determinations are made based on internal projections.**

External Data

- **Here are some examples of gathering external data:**
  - **Monitoring reports of international terrorist activities to determine if an event needs to be canceled**
  - **Analyzing industry trends to develop appropriate pricing for concession items**
  - **Tracking culinary advances to determine the most effective means of packaging and selling food items**
  - **Reading articles in trade publications to stay abreast of industry changes (e.g., *Barron's*, *Forbes*, *Bloomberg Businessweek*, and *The Wall Street Journal*)**
  - **Attending conferences to hear what other executives are saying about the industry**
  - **Reviewing government census reports to understand demographic changes in the possible fan base**

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External Data *(continued)*

- **The best sources for the sport industry are industry publications such as *Athletic Business, Athletic Management, Fitness Management, NCAA News, and Street & Smith's SportsBusiness Journal.***
- **Organizations regularly research specific industry benchmarks that can help establish criteria for success or failure. Organizations can use these publications—and numerous others—to obtain information about competitors or industry norms.**

Applying the Data

Financial planning requires two major activities:

- **Forecasting potential revenues**
- **Budgeting for future expenses**

Forecasting

- **Companies and sports organizations need to look to the future when undergoing financial planning.**
- **Forecasting involves uncertainty and historical performance, and it is usually less accurate than desired. Experience is often the best way of knowing of what really works.**

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Forecasting *(continued)*

- **Information for forecasting can come from the following:**
  - **Quantitative data (e.g., regression analysis, econometrics, naïve estimation, and smoothing)**
  - **Qualitative data (e.g., market research, sales force estimates, and focus groups)**
- **The most common approach for forecasting is the prior year's actual revenues that have been adjusted subjectively.**

Short-Term Planning

- **Short-term planning dictates how a business should proceed in a short time frame, usually less than two years.**
- **Planning is based on specific research and requires people to meet specific goals.**
- **It requires close scrutiny of internal variables such as cash flow and debt-related issues.**
- **Key aspects of short-term planning include how to effectively understand and make decisions based on working capital, net working capital, current ratio, acid test ratio, and the cash budget.**

Long-Term Planning

- **Long-term planning is often less clear because there are too many variables to allow for making accurate projections.**
- **Greater emphasis is placed on future external variables, such as industry trends, political climates, and technological advancements.**

Break-Even Analysis

- **Break-even analysis focuses on determining what is the price and cost point at which expenses will cover expected revenue.**
- **For example, if a team has a player payroll of $1 million, administrative expense of $500,000, and all other expenses of $500,000, then it will need to generate at least $2 million in admission fees to break even.**

Special Situations in Financial Planning

- **Start-ups**
  - **There is no established track record for the business on which to base planning.**
  - **Pro forma balance sheets and income statements for new businesses are very speculative**

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Special Situations in Financial Planning *(continued)*

- **Ownership changes**
  - **If the ownership change resulted from poor business performance, new ownership is probably going to institute changes in management, and the company will need to change its direction.**
  - **May lose customers or employees.**
  - **May need to reexamine product lines and markets to help with sales and start to turn a profit.**

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Special Situations in Financial Planning *(continued)*

- **Fast growth**
  - **It is a mistake to assume fast growth will continue forever into the future.**
  - **Businesses seizing new market niches or that enter new and growing markets are typically the ones associated with abnormally high growth.**
    - **These are the types of businesses that are at risk as other entrants, having witnessed the explosion in growth, try to steal market share (think about the growth of Silly Bandz and knockoffs).**

Building the Budget From the Ground Up

1. Examine the organization's mission, vision, goals, objectives, and other guiding information to make sure the budget is consistent with such material.
2. Undertake intensive research into the organization's strength and weaknesses, especially in terms of resources that might be needed as part of the budget.
3. Bring together all relevant stakeholders.
4. Review all the data collected in step 2 along with past financial statements and other information as discussed earlier in this chapter.

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Building the Budget From the Ground Up *(continued)*

5. **Develop a budget and then examine it for accuracy and feasibility.**
6. **Have key stakeholders examine the budget through a formal presentation process.**
7. **Obtain approval for the budget**
8. **Educate all key personnel about the budget and make sure employees understand their role in the process.**
9. **Implement the budget.**

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Building the Budget From the Ground Up *(continued)*

10. **Audit the process through variance analysis to track whether the budget is being followed and to identify any potential concerns.**
11. **Document the process for ease in launching the next budgetary cycle.**

Variance Analysis

- **Variance explores why a budget worked or did not work.**
- **There will always be a difference between what was projected and the actual results. The difference might be a few cents or millions of dollars.**
- **It would be impossible to create a budget that is 100% correct as there will always be variations in total expenses, amount of electricity utilized, and hundreds, if not thousands, of other variables.**

Class Discussion Topics

1. **Discuss a short-term plan for a perennially losing team and identify specific steps that could be taken to increase income or generate victories.**
2. **Discuss a long-term plan for a perennially losing team and identify specific steps that could be taken to increase income or generate victories.**
3. **What do you think is the most important primary data for a sport business to develop, and how can the business find this information?**

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Class Discussion Topics *(continued)*

4. **What do you think is the most important secondary data for a sport business to develop, and how can the business find this information?**
5. **Develop a sample survey you believe could be used to obtain critical information on which financial decisions could be made.**

Part II Case Study Discussion Topics

1. If you had seen the cash flow for this team not meeting expectations, what would you do?
2. If you were trying to examine the cash flow for a hockey team, how would you anticipate the revenue and expenses to be generated over the course of a year?
3. What do you think about the teams ticket price strategy, and what would you have done to generate additional revenue without alienating fans?
4. Do you think it is ethical to change the name of a ticket or seat and charge more due to that name change? What could be the impact of such a decision?